# Classification of Investment Bonds

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NO definition of an investment bond is broad enough to include every instrument ordinarily included in that phrase short of the general statement that it is a formal promise to pay expressed in a written instrument. Even to say that it is an instrument containing a promise to repay would be to give too narrow a definition, for the promise of a bond of the nature of a government perpetual annuity does not involve any stipulation for the repayment of principal. We have, then, to consider the classification of formal instruments containing promises to pay given as evidences of the commitment of investment funds to the promisor.

## Classification Based on Means of Payment

### *No Compulsory Payment*

*Government Bonds of a Sovereign Power.*—Our first broad classification is between those promises on which no compulsion can be brought to bear in the event of failure to fulfill the promise in accordance with its terms, and those on which compulsion can be brought to bear. This first broad general classification could be expressed in another way as stating the difference between bonds expressing the promise of a government to pay and the statement of the obligation of other promisors. Note the change in the phrase from the *promise* of a government to *the obligation of other promisors*. This change in the phrase is necessary because the promise of a government to pay is not in a legal sense an obligation. This fact arises out of the nature of sovereignty. Since the sovereign state is the law enforcing power and the force back of all legal mandates lies in the government, obviously, no legal compulsion can be brought to bear on the government. That one cannot sue the sovereign is a principle inherent in the very nature of law. So the fulfillment of the promise of a government rests on good faith. It should be kept in mind in this connection of government bonds that the several states of the Union are sovereign powers, retaining all the aspects of sovereignty not expressly surrendered by the constitution to the federal government. The several states did not make any surrender to the federal government that enables an individual to sue one of the sovereign states of the Union. Therefore, no individual can bring compulsion to bear on a state of the United States to make it fulfill a promise to pay. The several states did surrender their sovereignty so far, however, as to enable sister states of the Union to bring an action against them in the federal courts. One of the most notable of such actions is the suit of the state of Virginia against the state of West Virginia to compel the latter to carry out its undertaking to pay its share of the pre-Civil War debt of the state of Virginia from which the state of West Virginia separated at the time

of the Civil War. This limitation of sovereignty is so slight, however, that bonds of the states of the United States may be considered government bonds for all practical purposes. Indeed, they are absolutely such so far as individuals are concerned.

*Compulsory Payments*

*Municipal Bonds (Government Agencies).*—Note, however, that this distinction between promises to pay of a sovereign power and other promises to pay for the fulfillment of which legal compulsion can be brought to bear, is not the same thing as promises to pay for which the means of fulfillment rests in the taxing power. This difference raises the distinction between government bonds and the bonds issued by government agencies to which the sovereign power has entrusted some part of its governmental functions. These agencies go under the broad general name of municipalities and their bonds are broadly termed municipal bonds. Since the municipalities are created by the sovereign, it follows, in the nature of the case, that the sovereign can bring its compulsion to bear on them in any direction it sees fit. Municipalities have a right to issue bonds only by virtue of the authority given to them by the sovereign. When the sovereign has given authority it will compel the performance of the promise of the municipality to pay made within the scope of the authority. The fact that the promise to pay must be within the scope of the authority given makes especially important the usual investigation of the validity of municipal bonds by legal experts on behalf of the purchaser.

The payment of municipal bonds rests on the taxing power. This is true even of bonds issued to provide the funds for revenue producing municipal undertakings, as water works, which are commonly revenue producing municipal undertakings, or the less common municipally owned lighting plants, street railways, and other enterprises which municipalities sometimes engage in. The payment of interest and principal of bonds issued for these purposes is not limited to the earnings and assets of the particular enterprise but is a general municipal obligation. When we say that the fulfillment of the promise to pay rests on the taxing power we mean that it rests on the power of the municipality to appropriate for public purposes such part of the privately owned wealth as may be necessary. The sovereign through its courts will compel the municipality to make such an appropriation by the usual methods of taxation to fulfill the municipal promise to pay expressed in its bonds.

Municipal bonds require no subclassification other than that which arises naturally from the classes of issuing municipalities. In the word municipality we here include any agency to which the sovereign delegates any governmental powers, including counties, cities, townships, school and any other municipal districts.

*Special Assessment Bonds.*—One class of bonds lies between municipal obligations and the promises to pay of private obligors, this is the special assessment bond. Though issued by a municipality the resources out of which payment is to be made are limited to particular assets. Usually they are issued to provide the funds for

local improvements, as sewers or sidewalks. The property benefited becomes liable for all or part of the cost of the improvement. The municipality undertakes only to levy the assessments which are to provide the fund for repayment. If the value of the property benefited and liable should not be sufficient to meet the obligation the municipality would not have any further liability. A deficiency in the assets out of which payment is to be made might well happen in the case of over-improvement resulting from too sanguine expectation of the growth of population. These true special assessment bonds are to be distinguished from bonds on which the municipality is generally liable issued by it to refund its proportion of the cost of a local improvement which is not especially assessed against the benefited property.

*Corporation Bonds.*—When we think of investment bonds of private obligors in distinction from government and municipal bonds we usually have corporation bonds in mind. The broader distinction, however, would be the one indicated, namely, that between a public promise to pay resting on the taxing power, and a private obligation resting for its fulfillment on the value of privately owned property and the earning power of privately conducted business. Such an obligation can just as well, and even more simply, be created by a natural person as by a corporation, which is an artificial person. Indeed, in various jurisdictions a bond is the ordinary form of mortgage obligation, and an investment in ordinary individual mortgages is an investment in bonds. In attempting this classification of investment bonds, however, we are considering those bonds which have a fungible quality, that is, which represent equal parts of the same general obligation to pay. They are, as we say, bonds of an "issue." Such bonds are more commonly issued by corporations.

## CLASSIFICATION BASED ON SECURITY

Our first broad classification would draw the line of distinction between secured and unsecured bonds. A secured bond, besides representing the general obligation to pay, has specifically pledged to the fulfillment of the obligation some particular asset or assets. An unsecured bond represents simply the general obligation to pay, and the holder would have recourse only to assets not otherwise specifically pledged. Unsecured bonds are generally called "debentures" in this country, from the Latin *debere*, to owe. In Great Britain and Canada, however, the word debenture is generic and includes both secured and unsecured bonds.

### *Secured Bonds—Direct Access to Assets of the Obligator*

*Tangible Property—Mortgage Bonds.*—Secured bonds may be classified according to the assets pledged. The assets may be intangible, as the stocks or bonds of other corporations, or may be tangible personal property or may be real estate. Let us take the last first. The ordinary way of giving the security of real property is by mortgage, and bonds secured on real estate are generally called mortgage bonds. If they represent the first claim against real estate they are first mortgage bonds. Bonds representing a second or more remote claim against real estate are seldom called second mort-

gage bonds, or third or fourth, as the case may be. Some euphemy is ordinarily used to designate them, taken from some other aspect of the security, as "general mortgage bonds." It should also be kept in mind that a bond may be secured by a first mortgage on some particular asset but have the security only of a second or even more junior mortgage on other assets. If it has the security of a first mortgage as to any asset it is entitled to be called a first mortgage bond. Usually in that case the juniority of the security as to other assets is indicated by some further appellation, as "first and general mortgage bond." In relation to their priority of claims against assets, bonds are called "senior" and "junior."

*Corporation Bonds.*—Corporation bonds are usually secured by the mortgage of the tangible personal property of the corporation as well as by real estate. That is, the mortgage securing the bonds is a chattel mortgage as well as a real property mortgage. This fact arises out of the nature of the situation. The real property, including the improvements on it, as factory buildings, or whatever they may be, derives its income producing value through its use as part of a productive enterprise. For his real protection the investor in the bonds of the corporation needs to be in a position to get the benefit of the continuous productive value of the property, and to do this must have all the chattels that go with the business as well as the real estate. So, regularly, the bond is given the same priority of claim against the tangible personal property used in the business that it has against the real estate.

*Intangible Property—Collateral Bonds.*—Bonds secured only by the pledge of intangible personal property, as by bonds and stocks, are not mortgage bonds. That is, a mortgage applies only to tangible property, chattels or real estate. The security of stocks and bonds is given by way of pledge and made effective usually by depositing the pledged securities with a trustee to hold under the terms of the trust indenture expressing the pledge. Bonds so secured are called "collateral bonds."

Bonds may be secured by both the deposit of collateral and by mortgage on real estate and chattels. Usually if there is a mortgage the bond takes its name from that and the deposit of the collateral is regarded as incidental and in the nature of additional security. In short, from the aspect of security, very little can be taken for granted from the name of the bond. The investor needs to investigate in each case and find precisely what security has been given.

It should be remarked that frequently all the mortgage bonds of a given issue are deposited as collateral security for bonds of another issue. In that case the bonds of the second issue have, in effect, the same mortgage claim as the deposited bonds. This situation frequently arises through a parent corporation taking all the bonds of an issue of a subsidiary and pledging them as collateral security for an issue of bonds of the parent company. In this way the parent company is able to borrow on the security of its general credit and give at the same time virtually a mortgage security on the assets of the subsidiary. Sometimes, however, a company may pledge its own bonds as collateral security for an

issue of its own. At first thought this may seem a complication without an advantage. Why should not the corporation sell the bonds of the original issue? This situation ordinarily arises out of a change in the money market after the original issue was authorized. Interest rates have gone up. The original bonds were authorized to run for a long period. To sell them on the terms that may now be obtained would be to impose on the corporation for the entire term of the bonds the burden of the money rates now existing. If the management of the corporation believes that interest rates are going down, the simplest solution of the financing problem immediately before it is to take the authorized long term bonds and pledge them as collateral security for bonds with a shorter term, maturing at such a time as the management believes will be more favorable for the issue of long term securities. The management believes that when the collateral bonds mature it will be able to sell advantageously the long term bonds deposited.

Ordinarily, in the case of individual obligors, only specific assets existing at the time the mortgage is given come under the lien of the mortgage. Corporation mortgages contain a stipulation that the mortgage is given not only on the property owned by the corporation at the time but also on any property the corporation may acquire in the future. Such an agreement is termed a future acquired property mortgage. Such future acquired property mortgages have led to the formation of subsidiary corporations in order that new assets acquired may be mortgaged not subject to the lien of the parent company which uses bonds of the subsidiary as collateral for an issue of its own.

Parent companies also guarantee bonds of subsidiaries. Sometimes such a guarantee is given as part of the payment for a lease. It is these two situations which most frequently give rise to guaranteed bonds. It is desirable from the viewpoint of the investor that the guarantee be endorsed on the guaranteed security.

Our discussion of corporation bonds has indicated those for the payment of which the bondholder may reach the assets of the obligor. A special class of bonds contain a stipulation that interest is payable only out of income. Such bonds are called income bonds.

## Classification on Authority of the Issue

So far our classification of bonds has been from the primary viewpoint of the obligation, that is, whether the promise to pay is enforceable or not, and the security, that is, whether the bondholder relies on the general credit of the obligor or has in addition a direct claim on specific assets that would come prior to the rights of general creditors. But aspects other than that of security lead to other classifications. One classification can be made on the basis of the authority to issue.

### *Open and Closed Mortgage Bonds*

This may be considered really a sub-classification of mortgage bonds. It is necessary that stockholders authorize the creation of a mortgage. Directors of a corporation may not voluntarily cease to do the business contemplated by the stockholders when they committed their funds to the

enterprise, and may not voluntarily do that, the natural result of which might be the ceasing to do business. Therefore, directors may not sell all the assets of a corporation, converting into cash its means of continuing business. Ordinarily the authorization of a bare majority of stockholders would not be sufficient to effect a sale of all the assets of a corporation. Statutes usually declare the size of the majority required. To mortgage the property might result, through foreclosure, in a corporation being deprived of the means of doing business. A mortgage is in itself a conveyance. To be sure the same result might follow any indebtedness in some other manner, but the possible result of the mortgage is direct and obvious. Therefore, stockholders' authority is required to mortgage and to create a debt secured by mortgage. The stockholders authorize the amount of the mortgage debt. If bonds representing the entire authorized debt are issued the mortgage is said to be "closed," and the bonds are closed mortgage bonds. If bonds are not issued up to the entire mortgage debt authorized the mortgage is open and the bonds are open mortgage bonds, but more commonly spoken of as "authorized and unissued bonds."

*Refunding Bonds.*—If a restriction is placed on the issuance of all or part of the authorized and unissued bonds, limiting their issuance to the one purpose of providing funds for the payment of other, and usually senior bonds, the issue is called a refunding bond issue. The usual provision is that the authorized and unissued bonds, or such part of them as are reserved for this purpose, may be certified by the trustee only on the receipt of an equal number of bonds of the issue which is to be refunded.

## CLASSIFICATION ACCORDING TO MATURITY

Another basis of classification of bonds lies in the maturity and in the provisions, if any, for supplying funds with which to make payment at maturity. Bonds may be perpetual, that is, without any due date. This is different from a demand obligation, for which, in a sense, it may be said that every day is a due day.

### *Perpetual*

Government bonds are frequently perpetual. In this country bonds are seldom a perpetual security. Still there are a number of corporation issues in this country without a due date. Bonds may be "redeemable," that is, the issuer may reserve the right to pay before the date on which the issuer is obliged to pay. Ordinarily the redemption right is exercisable only in the payment of a premium, that is, some stated amount above the obligation to pay at maturity. Some specific provision may be made for the accumulation of a fund with which to meet the obligation to pay at maturity. Such a fund is termed a "sinking fund" and the bonds are called sinking fund bonds. A sinking fund provision equalizes or distributes the burden of the debt.

### *Serial Bonds*

A distribution of the burden of the debt may be provided by making an issue of bonds fall due, not all on the same date, but part each year through the entire period, or part of the period covered by the debt. Such bonds are called serial bonds.

### *Convertible Bonds*

Perhaps the conversion feature of bonds may be considered most appropriately at this point. Sometimes bonds contain a stipulation giving the holder the option to convert into a junior security, usually stock of the corporation, under the stated condition of time and price. This conversion stipulation may be thought of in close connection with the classification according to maturity because, in a sense, an exercise of the option to convert is an acceleration of maturity in that it brings the particular obligation to an end. The conversion stipulation contains the condition of the time within which the option may be exercised. That is, the right to convert may begin at once or at some later date and continue till the due date of the bond, or the right may terminate earlier than the due date. The time limits are explicit and readily understandable. More difficulty sometimes arises over the price conditions. If the exchange is at par for par, that is, a thousand dollar bond may be exchanged for ten shares of stock of the par value of one hundred dollars a share, the situation is clear enough. But the stipulation is sometimes that the bond may be converted into stock at, say, 150. This means that it would require fifteen thousand dollar bonds to effect an exchange for one hundred shares of stock at the par value of one hundred dollars a share. The stock is paid for, so to speak, at 150 with the debt considered as worth the full amount of the obligation. Sometimes the option may be more complex, as that the bonds may be converted at 75 into stock at 150. This means that the bonds are worth only 75 cents on the dollar of the obligation to convert into stock at a price of 150. This particular ratio could be expressed by stating that the bonds could be converted (at par) into stock at 200. A conversion stipulation has been made in a number of government bonds issued during the war to the effect that the particular issue may be converted into another issue or issues. Of course, this is not a conversion into a junior security as we have stated of corporation bonds, as there is, generally speaking, no seniority or juniority of government bonds, but simply a change from one government promise into another with different terms.

## CLASSIFICATION AS TO PAYMENT OF INTEREST

Bonds are further classified with respect to the manner of transfer and interest payment into registered and coupon bonds. The creditor whose claim is represented by a registered bond can transfer his right to receive payment only by an entry on the books of the corporation. Payment of interest is made by check to the registered owner mailed to the registered address. Since title can pass only by change of registration such bonds are not negotiable.

## CLASSIFICATION ACCORDING TO TAX POSITION

A special stipulation frequently contained in bonds has been given such importance through the course of federal income tax legislation as to have given another basis of classification for bonds. Agreements have frequently been inserted in bonds by which the obligor has promised to pay any tax which the obligor may be

required to retain or withhold from the obligee. These agreements were doubtless inserted for many years without very much thought of the effect or expectation that the obligor would, in fact, ever be called on to suffer any loss on account of them. Neither did the investor pay any attention to them or pay a dollar more for the bonds on account of them. Years before there was any thought of an income tax with a "collection at the source" feature the writer came in contact with the British income tax with its "collection at the source" features, and called attention to the dangers of these tax covenants to the obligor. When our "collection at the source" statute was passed these tax covenants blazed with importance. When "collection at the source" was abandoned prices of bonds had become so affected by the presence of the tax covenant that it was deemed expedient to retain the "withholding at the source" feature in relation to bonds. So on the basis of the federal income tax, bonds are known as "tax covenant" and "non tax covenant" bonds.

The laws of our multiplicity of jurisdictions vary widely in respect to the taxation of securities, and bonds not subject to taxation in given jurisdiction are known as tax exempt in that jurisdiction and those subject to taxation are called taxable in the jurisdiction.

- Classification depending on the promise to pay
  - No compulsion
    - Government bonds, *i.e.* of sovereign powers, including sovereign states of federations
  - Compulsion
    - Municipal bonds (government agencies)
    - Private bonds—*i.e.* of individual, associated and corporation obligors
- Classification depending on the means of payment
  - Bonds depending on the taxing power
    - Government
    - Municipal
  - Bonds for the payment of which direct access may be had to assets of the obligor
    - Private bonds that contain absolute promise to pay
  - Bonds for the payment of which, so far as interest is concerned, access may be had to earning power only
    - Income bonds
- Classification according to security
  - Debentures
    - No specific security but depending on the general credit of the obligor enforceable through judgment and levy of execution
  - Mortgage bonds
    - Bonds secured by mortgage on tangible assets
  - Collateral bonds
    - Bonds secured by the pledge of intangibles—as stocks and bonds
- Classification according to the element of time in relation to the specific security
  - Future acquired property mortgage bonds
  - Specific mortgage bonds (*i.e.* relating only to assets existing and mortgaged at the time the mortgage is created)
- Classification according to authority to issue
  - Closed mortgage bonds
  - Open mortgage bonds
    - Refunding bonds
- Classification according to provision for maturity
  - Perpetual
  - Serial
  - Sinking fund
  - Convertible
  - Redeemable
    - Optional (*i.e.* redeemable after a certain time)
- Classification according to manner of transfer and payment of interest
  - Registered
  - Coupon
- Classification according to tax position
  - Federal Taxation
    - Taxable
    - Tax exempt
    - Tax covenant
    - Non tax covenant
  - State taxation
    - Taxable
    - Tax exempt